

Message Text

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E.O. 11652 N/A

TAGS: EEWT, XH

SUBJECT: EAST-WEST FOREIGN TRADE BOARD STUDY: COMPENSATION
ARRANGEMENTS IN EAST-WEST TRADE

REF: STATE 12648, 74 MOSCOW 19037, 75 MOSCOW 4936, 75 MOSCOW
10244,

1. OUTLINE FOR EAST-WEST TRADE STUDY TRANSMITTED STATE REFTL,
IN EMBASSY'S VIEW, PROVIDES COMPREHENSIVE FRAMEWORK FOR STUDY
UNDER WAY. WE HAVE NO ADDITIONAL TOPICS TO SUGGEST FOR INCLUSION
IN OUTLINE.

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2. FOLLOWING COMMENTS RELATE TO SOVIET APPROACH TO COMPENSATION
PROJECTS WITHOUT REFERENCE TO ATTITUDES OR OPPORTUNITIES IN OTHER
EAST EUROPEAN COUNTRIES. COMMENTS ARE KEYED TO TOPIC HEADINGS
LISTED IN STUDY OUTLINE.

3. I. TYPES OF COMPENSATION ARRANGEMENTS. THE TWO US-SOVIET COMPENSATION PROJECTS ALREADY CONTRACTED AND NOW UNDER CONSTRUCTION PROVIDE FOR LIQUIDATION OF US INVESTMENT IN FORM OF INDUSTRIAL PRODUCTS (ACETIC ACID IN ONE INSTANCE AND AMMONIA, POTASH AND UREA IN THE OTHER) OVER SPECIFIED TIME PERIOD, AND SEVERAL PROJECTS UNDER DISCUSSION ENVISION SIMILAR ARRANGEMENT. FOR ABOUT 18 MONTHS SOVIETS HAVE BEEN EXAMINING FEASIBILITY OF SOME ALTERNATIVE WHICH WOULD PROVIDE LONGER-TERM, PERHAPS INDEFINITE ASSOCIATION BETWEEN SOVIET ENTERPRISE AND WESTERN TRADING PARTNER. SOVIET GOAL IS TO OBTAIN CONTINUED UPDATING OF TECHNOLOGIES UTILIZED IN MANUFACTURING PROCESS THROUGH OFFER TO PROSPECTIVE TRADING PARTNER OF VESTED INTEREST IN JOINT ENTERPRISE. BECAUSE SOVIET LAW DEFINING MEANS OF PRODUCTION AS PROPERTY OF STATE APPEARS TO PROHIBIT FOREIGN EQUITY PARTICIPATION IN ANY PRODUCTION PLANT LOCATED IN USSR, SOVIETS SEEM TO BE MOVING TOWARD CONCEPT OF CONSULTANT STATUS FOR FOREIGN INVESTOR, BUT UNSOLVED PROBLEM REMAINS DEFINITION OF FOREIGNER'S INTEREST IN THE ENTERPRISE AFTER HIS INITIAL INVESTMENT HAS BEEN LIQUIDATED THROUGH REGULAR COMPENSATION PAYMENTS. EXISTING COMPENSATION-TYPE PROJECTS IN USSR INVOLVING WESTERN EUROPEAN AND JAPANESE COMPANIES FOLLOW SAME GENERAL PATTERN. INTERESTINGLY, THE BULK OF THESE AGREEMENTS HAS BEEN IN CHEMICAL AREA, INVOLVING UREA/AMMONIA (CREUSTO-LOIRE, MITSUI/TOYO ENGINEERING, MONTEDISON/ENI) POLYETHYLENE (CJB/UNION CARBIDE), POLYPROPYLENE (MONTEDISON). FOR ITALIAN COMPANIES, IT WOULD APPEAR THAT INVESTMENTS ON COMPENSATION BASIS IN USSR ARE PREFERABLE TO INVESTMENTS IN ITALY, PARTICULARLY SINCE GOVERNMENT-SUBSIDIZED FINANCING IS AVAILABLE IN CASE OF USSR. ANOTHER SET OF DEALS WHICH FALLS INTO THE COMPENSATION CATEGORY ARE THOSE CONCLUDED BY WESTERN EUROPEAN (FRENCH, AUSTRIAN, ITALIAN AND FRG) STEEL AND NATURAL GAS TRANSMISSION COMPANIES UNDER WHICH WIDE-DIAMETER PIPE IS SUPPLIED ON CREDIT WITH REPAYMENT IN FORM OF NATURAL GAS DELIVERIES. FINLAND, WHICH IS IN SOMETHING OF SPECIAL CATEGORY, IS PARTICIPATING IN COMPENSATION DEALS INVOLVING PULP AND IRON ORE PELLETS. JAPANESE FIRMS ARE NOW INVOLVED IN MAJOR COMPENSATION PROJECTS INVOLVING WOOD PRODUCTS LIMITED OFFICIAL USE LIMITED OFFICIAL USE

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(FIRST DEAL CONCLUDED BACK IN 1969) AND COAL. OUTSIDE RAW MATERIALS AREA, SOME OF JAPANESE-BUILT AND FINANCED PLANTS SUCH AS BAKU AIR CONDITIONER PLANT INVOLVED PARTIAL REPAYMENT IN FORM OF FINISHED PRODUCT. THIS LATER TYPE OF DEAL IS MUCH MORE ATTRACTIVE TO SOVIETS THEN RAW MATERIAL PROJECTS, BUT PROBLEMS IN AREAS SUCH AS QUALITY CONTROL HAVE MADE CONCLUSION OF SUCH DEALS VERY DIFFICULT.

4. II. SIMILARITIES/DIFFERENCES RE TRADITIONAL FOREIGN INVESTMENT. ESSENTIAL DIFFERENCES ARE: (1) ABSENCE OF OPPORTUNITY FOR EQUITY PARTICIPATION IN JOINT ENTERPRISE; (2) ABSENCE OF OPPORTUNITY FOR FOREIGN PARTNER TO EXERCISE SUPERVISORY ROLE OVER LABOR; (3) REQUIREMENT THAT COMPENSATION BE MADE IN PRODUCT RATHER THAN

MONEY. WHILE SOME SOVIETS (CHIEFLY EMPLOYEES OF STATE COMMITTEE FOR SCIENCE AND TECHNOLOGY) HAVE FREQUENTLY IMPLIED THAT THESE DIFFERENCES CAN BE LARGELY RESOLVED THROUGH SUITABLE EUPHEMISMS IN DEFINING FOREIGN ROLE IN A GIVEN PROJECT, WE HAVE YET TO SEE ANY FIRM SOVIET PROPOSAL WHICH WOULD REFLECT SUBSTANTIAL CHANGE IN FACTORS LISTED ABOVE.

5. III. SIGNIFICANCE OF COMPENSATION ARRANGEMENTS. IN SOVIET TRADE WITH JAPAN, ITALY, AUSTRIA, FINLAND, FRANCE, AND THE FRG, THE TWO-WAY MOVEMENT OF EQUIPMENT/RAW MATERIALS UNDER COMPENSATION DEALS HAS COME TO REPRESENT A SUBSTANTIAL SHARE OF BILATERAL TRADE. ASSUMING THAT DEALS WHICH HAVE BEEN CONCLUDED ARE SUCCESSFULLY REALIZED, THIS SHARE SEEMS CERTAIN TO INCREASE, PARTICULARLY WHEN SOVIET DELIVERIES OF NATURAL GAS TO FRG, ITALY, AUSTRIA AND FRANCE BEGIN ON LARGE SCALE. IN CASE OF JAPAN, LARGE-SCALE PROJECTS IN AREAS SUCH AS FOREST PRODUCTS AND COAL HAVE PROVIDED BASIS FOR VERY LARGE SALES OF CONSTRUCTION/MINING EQUIPMENT TO USSR. SINCE FORMATION OF THE BILATERAL US-SOVIET COMMERCIAL COMMISSION MORE THAN THREE YEARS AGO, SOVIET MEMBERS HAVE EMPHATICALLY AND REPEATEDLY STATED THAT ANY MAJOR AND STABLE INCREMENT IN TRADE IN NON-AGRICULTURAL COMMODITIES WILL COME ABOUT THROUGH COMPENSATION ARRANGMENTS. THEY POINT TO OCCIDENTAL PETROLEUM DEAL FOR TWENTY-YEAR TWO-WAY MOVEMENT OF \$1 BILLION ANNUALLY IN AMMONIA/POTASH, UREA AND SUPERPHOSPHORIC ACID AS EXAMPLE OF KIND OF COMPENSATION PROJECT THEY WANT TO ENCOURAGE. NORTH STAR AND YAKUTIA NATURAL GAS PROJECTS, IF CARRIED OUT WOULD PROVIDE COMPARABLE SURGES IN BILATERAL TRADE TURNOVER. SOVIETS WERE PLEASANTLY SURPRISED TO HEAR FORMER CEA CHAIRMAN MCCrackEN
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ESTIMATE DURING A VISIT LAST YEAR THAT POTENTIAL ANNUAL BILATERAL TRADE TURNOVER IS IN \$10 BILLION RANGE. CLEARLY, WELL OVER 50 PERCENT OF SUCH A LEVEL WOULD NECESSARILY BE ACHIEVED THROUGH COMPENSATION ARRANGEMENTS.

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6. IV. IMPACT OF COMPENSATION ARRANGEMENTS. A. SHORT TERM.
THE ENORMOUS SCALE OF MAJOR SOVIET COMPENSATION PROJECTS TENDS TO REQUIRE MASSIVE INVESTMENT OF HIGHLY TRAINED PERSONNEL AS WELL AS TECHNOLOGICALLY ADVANCED EQUIPMENT ON PART OF FOREIGN TRADING PARTNER. APART FROM MAJOR INTERNATIONAL ENGINEERING FIRMS GEARED TO SUCH DEPLOYMENT OF HUMAN RESOURCES, ONLY THE LARGEST INDUSTRIAL COMPANIES POSSESS SUFFICIENT TRAINED MANPOWER TO UNDERTAKE SOVIET COMPENSATION PROJECTS WITHOUT PREJUDICE TO OTHER SEGMENTS OF THEIR ACTIVITY. ACCORDING TO FOREIGN BUSINESSMEN IN MOSCOW, THE DRAIN ON FIAT'S ENGINEERING RESOURCES IMPOSED BY CONSTRUCTION OF THE TOGLIATTIGRAD AUTOMOBILE PLANT CONSTITUTED SINGLE MOST SERIOUS PROBLEM FOR THE ITALIAN FIRM. ON BASIS OF LIMITED OFFICIAL USE
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EXPERIENCE TO DATE, IT APPEARS THAT FINANCING REQUIREMENTS AND PROBLEMS IN MARKETING OFF-TAKE FOR SOVIET COMPENSATION PROJECTS HAVE TENDED TO ENCOURAGE FORMATION OF PROJECT-ORIENTED COMBINATIONS, BOTH NATIONAL AND MULTINATIONAL, OF WESTERN COMPANIES. MAGNITUDE OF SOVIET PROJECTS HAVE FORCED WESTERN COMPANIES TO THINK IN LARGER TERMS THAN THEY HAVE TRADITIONALLY DONE AND TO ADOPT MORE FLEXIBLE FORMS OF DOING BUSINESS IN RESPONSE TO REQUIREMENTS OF DEALING WITH SOVIETS. IT IS POSSIBLE THAT ORGANIZATIONAL RESPONSES OF WESTERN EUROPEAN AND JAPANESE FIRMS TO THE REQUIREMENTS OF SOVIET COMPENSATION PROJECTS WILL MAKE THEM MORE FORMIDABLE COMPETITORS FOR US COMPANIES IN THIRD MARKETS.

7. B. LONG TERM.
GIVEN THE MAGNITUDE OF REQUIRED INVESTMENT IN SOVIET COMPENSATION PROJECTS, PRODUCE MIX PROVIDED IN REPAYMENT NECESSARILY INVOLVES LARGE QUANTITIES. SOVIET COMPENSATION PROPOSALS THUS FAR CONSIDERED SERIOUSLY BY US FIRMS WOULD PROVIDE RAW AND SEMI-FINISHED PRODUCTS CONSUMED GLOBALLY IN INCREASING MEASURE (MINERAL FERTILIZERS, INDUSTRIAL CHEMICALS, ENERGY SOURCES,

CELLULOSE, STEEL AND ALUMINUM BARS AND SHAPES), AND WHILE SOVIET MANUFACTURES HAVE YET TO APPEAR IN LARGE QUANTITIES ON WORLD MARKETS, SOVIET EFFORTS TO INTEREST FOREIGN FIRMS ON COMPENSATION BASIS IN SUCH PROJECTS AS KAMAZ TRUCK PLANT, CHEBOKSARI TRACTOR FACTORY AND PROJECTED SIBERIAN TRUCK PLANT CLEARLY POINT TO PUSH BY MOSCOW IN THIS DIRECTION. PRINCIPAL PRODUCT AREAS IN WHICH SOVIETS SEE THEMSELVES AS POTENTIAL MAJOR EXPORTERS INCLUDE AUTOMOTIVE/TRANSPORT EQUIPMENT (AIRFRAMES, TRUCKS, TRACTORS, PASSENGER AUTOMOBILES, MOTORCYCLES, MOTOR SCOOTERS, BICYCLES), INDUSTRIAL MACHINERY (ESPECIALLY MACHINE TOOLS AND POWER GENERATING EQUIPMENT). SIGNIFICANT PENETRATION OF WORLD MARKETS FOR THESE GOODS IS NOT IN THE CARDS FOR MOSCOW IN THE SHORT TERM, BUT COULD BECOME A DISTURBING FACTOR BY THE END OF THE NEW 1976-80 FIVE YEAR PLAN. NATURE OF LONGER-TERM CHANGES WILL DEPEND IN LARGE MEASURE UPON NATURE OF PRODUCTS INVOLVED. IF SOVIETS ARE SUCCESSFUL IN SHIFTING FOCUS OF COMPENSATION PROJECTS AWAY FROM CURRENT CONCENTRATION ON RAW MATERIALS/SEMI-FINISHED GOODS, AS THEY HOPE TO DO, THIS WILL INEVITABLY INVOLVE MUCH CLOSER RELATIONSHIP BETWEEN WESTERN COMPANIES AND SOVIETS. THIS NEW RELATIONSHIP COULD WELL COME TO INVOLVE COOPERATION IN "DOWN-STREAM" AREA OF MARKETING, SPARE PARTS, SERVICE, ETC. ON QUANTITATIVE SIDE, IT APPEARS CERTAIN

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THAT COMPENSATION PROJECTS WILL RESULT IN SUBSTANTIAL INCREASES IN TWO-WAY TRADE FLOWS. THIS IS BECAUSE MANY OF THE PROJECTS WHICH ARE BEING AND WILL BE UNDERTAKEN ON A COMPENSATION BASIS COULD NOT BE UNDERTAKEN ON ANY OTHER BASIS DUE TO:

A) LACK OF SOVIET HARD-CURRENCY RESOURCES; AND B) SOVIET RELUCTANCE TO TAKE ON HARD-CURRENCY DEBT EVEN UP TO ITS APPARENT ABILITY OF REPAY. IN THIS RESPECT, COMPENSATION PROJECTS REPRESENT PARTIAL SOLUTIONS TO BARRIERS POSED BY LIMITED SOVIET HARD-CURRENTY EARNINGS FROM TRADITIONAL TRADE AND GENERALLY CONSERVATIVE APPROACH OF THE SOVIET LEADERSHIP ON THE DEBT QUESTION.

8. C) CHANGES IN TRADE THROUGH COMPENSATION ARRANGEMENTS.

GIVEN THE USSR'S LONG-TERM GOAL OF SHIFTING THE BALANCE OF SOVIET EXPORTS FROM RAWMATERIALS TO MANUFACTURED GOODS, ANY COMPENSATION ARRANGMENT WITH A FOREIGN FIRM WHICH MAKES THE LATTER AVAILALBLE TO FACILITATE PENETRATION OF EXTERNAL MARKETS (SALES ARRANGEMENTS, FACTORY-APPROVED MAINTENANCE, SPARE PARTS SUPPLY, DEALER NETWORKS) WOULD BE HIGHLY USEFUL FOR SOVIETS. BECAUSE THE SOVIET ECONOMIC STRUCTURE PROVIDES OPTIMAL FREEDOM TO SOVIET PLANNERS TO ALLOCATE OUTPUT BETWEEN DOMESTIC AND FOREIGN PURCHASERS, AND IN VIEW OF (1) THE TRADITIONAL LINKAGE BETWEEN USSR'S FOREIGN POLITICAL AND ECONOMIC TIES. (2) CUSTOMARY AGGRESSIVE SOVIET EFFORTS TO EXPAND HARD CURRENCY EARNINGS. (3) NATURE OF SEPARATION OF USSR'S DOMESTIC AND FOREIGN TRADE, WHICH FACILITATES FIXING OF EXPORT PRICES WITH MINIMUM REFERENCE TO PRODUCTION COSTS, SOVIETS MAY BE EXPECTED TO PURSUE FOREIGN MARKETS VIGOROUSLY AND TO TAKE

MAXIMUM ADVANTAGE OF COMPETITORS' PROBLEMS. IN A CLIMATE OF EXPANDING WORLD TRADE RESULTING DISRUPTION OF ESTABLISHED TRADING PATTERNS MAY NOT BE SIGNIFICANT.

9. IN BROADER SENSE, DEVELOPMENT OF CLOSER, LONG-TERM RELATIONSHIP BETWEEN SOVIETS AND WESTERN COMPANIES WILL TEND TO MAKE SOVIETS MORE A PART OF THE WORLD ECONOMY AND WILL REDUCE BOTH THEIR INTEREST IN AND POTENTIAL FOR ACTIONS WHICH MIGHT BE DISRUPTIVE OF INTERNATIONAL TRADE AND ECONOMIC PATTERNS. TO THE EXTENT THAT US FIRMS ARE UNABLE TO PARTICIPATE IN COMPENSATION PROJECTS, DUE EITHER TO LACK OF FINANCING OR A RELUCTANCE TO BECOME INVOLVED OVER THE LONG-TERM IN THE USSR, OUR SHARE OF SOVIET FOREIGN TRADE WILL ALMOST CERTAINLY DECLINE AS WESTERN EUROPEAN AND JAPANESE FIRMS BECOME MORE ACTIVE IN COMPENSATION
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PROJECTS. THIS JUDGMENT IS BASED ON OUR ASSUMPTIONS THAT: A) DUE TO A LACK OF HARD CURRENCY SOVIETS WILL CONTINUE TO PRESS COMPENSATION PROJECTS; AND B) WESTERN EUROPEAN/JAPANESE FIRMS WILL CONTINUE, WITH INCENTIVE OF GOVERNMENT-SUBSIDIZED CREDITS, TO ENTER INTO THESE PROJECTS.

10. V. ECONOMIC EFFECTS IN UNITED STATES. A.
ECONOMIC IMPACT ON US INDUSTRY 1) IN GENERAL, WE DO NOT BELIEVE THAT PARTICIPATION IN COMPENSATION PROJECTS BY US FIRMS SHOULD BE VIEWED AS QUALITATIVE DIFFERENT FROM NORMAL TRADE ARRANGEMENTS. IN TERMS OF US EXPORTS, THESE PROJECTS SHOULD GENERAL SUBSTANTIAL BENEFITS IN TERMS OF EMPLOYMENT. THIS ASSUMES, OF COURSE, THAT US FIRMS WOULD SUPPLY, FORM THEIR DOMESTIC PRODUCTION, THE MACHINERY AND EQUIPMENT FOR THESE PROJECTS. SHOULD FIRMS SIMPLY PROVIDE TECHNOLOGY FROM US, WITH EQUIPMENT SUPPLIED OUT OF THIRD COUNTRIES, THE BENEFICIAL IMPACT WOULD BE MUCH LESS. IN THIS RESPECT, AVAILABILITY OF CREDITS IS A KEY QUESTION. ON IMPORT SIDE, THE REQUIRMENT TO MARKET A SUBSTANTIAL PROPORTION OF THE OFF-TAKE FROM COMPENSATION PROJECTS IN THE US COULD IN SOME CASES CAUSE PROBLEMS BY REDUCING DOMESTIC EMPLOYMENT. THIS PROBLEM PROMISES TO BE MUCH MORE MANAGEABLE AS LONG AS COMPENSATION PROJECTS ARE CONCENTRATED IN RAW MATERIALS SEMI-FINISHED GOODS AREAS. TO EXTENT THAT THESE PRODUCTS ARE ALEADY BEING IMPORTED FROM OTHER SOURCES, THE INFLOW OF SOVIET PRODUCTS WOULD NOT MATERIALLY HARM US PRODUCERS. WE WOULD ALSO POINT OUT THAT MANY OF THE PROJECTS WHICH ARE BEING DISCUSSED ARE OF A SORT WHICH COULD NOT BE UNDERTAKEN IN US, EITHER FOR ENERGY OR ENVIRONMENTAL CONSIDERATIONS. CONSEQUENTLY, WE BELIEVE THAT OVERALL IMPACT ON US ECONOMY FROM COMPENSATION DEALS WOULD BE BENEFICAL.

B. EFFECTS ON US EXPORTS TO THIRD COUNTRIES. COMPENSATION ALEADY CONCLUDED OR NOW UNDER ACTIVE DISCUSSION DO NOT IN GENERAL INVOLVE PRODUCTS WHICH US CURRENTLY EXPORTS IN LARGE QUANTITIES. CONSEQUNTLY, DIRECT IMPACT OF THESE PROJECTS ON US EXPORTS WOULD NOT APPEAR TOO SERIOUS. SHOULD SOVIET SUCCEED IN APPLYING

COMPENSATION PRINCIPLE TO FINISHED GOODS AREA, PROBLEMS COULD ARISE
FOR US EXPORTS ON THIRD MARKETS. IT SEEMS UNLIKELY TO US,
HOWEVER, THAT A) SOVIETS WILL BE SUCCESSFUL IN NEAR FUTURE IN
MOVING INTO COMPENSATION PROJECTS INCLUDING EXPORT OF FINISHED
GOODS AND THAT B) SOVIET FINISHED GOODS PRODUCED UNDER ANY
COMPENSATION ARRANGEMENT WILL BE OF SUFFICIENTLY HIGH QUALITY TO
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REPRESENT MAJOR THREAT TO US EXPORTS.

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11. VI. MOTIVATION. A. USSR, WE SEE SOVIETS AS MOTIVATED PRIMARILY
BY HARD CURRENCY LIMITATIONS, DESIRE TO SECURE ACCESS TO WESTERN
MARKETS, AND ACQUISITION OF WESTERN TECHNOLOGY IN THEIR PUSH FOR
COMPENSATION PROJECTS. ACHIEVING OF SELF-SUFFICIENCY, LONG A SOVIET
GOAL, DOES NOT APPEAR TO BE MAJOR CONSIDERATION, PARTICULARLY SINCE
LONG-TERM RELATIONSHIPS IMPLIED IN COMPENSATION PROJECTS WOULD TEND
TO WORK AGAINST REAL SELF-SUFFICIENCY. RE POINT VI (A) 6 ON ECONOMIES

OF SCALE, PROJECTS WHICH SOVIETS WISH TO UNDERTAKE ON COMPENSATION BASIS ARE GENERALLY GRANDIOSE, AND THIS IS ONE OF PROBLEMS WHICH POTENTIAL WESTERN PARTNERS MUST FACE. WHILE CUSTOMARY SOVIET JUSTIFICATION FOR FOREIGN INVOLVEMENT IN USSR'S DOMESTIC ECONOMY INCLUDES PHRASEOLOGY LIMITED OFFICIAL USE
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ABOUT "INTERNATIONAL DIVISION OF LABOR" (READ PLANT SPECIALIZATION, ECONOMIES OF SCALE, INVESTMENT OF CAPITAL IN AREAS AND INDUSTRIES WHERE

SKILLED LABOR IS ALREADY AVAILABLE), WE ARE NOT CERTAIN THAT ECONOMIES

OF SCALE CAN BE CONSIDERED ALONE AS MAJOR SOVIET GOAL.

B. WESTERN. IN GENERAL, WESTERN COMPANIES APPEAR TO PREFER TO AVOID COMPENSATION-TYPE PROJECTS IN USSR AND HAVE ADOPTED THIS FORM OF VENTURE ONLY BECAUSE MORE TRADITIONAL ARRANGEMENTS WERE NOT ACCEPTABLE TO SOVIETS. ONE CAVEAT SHOULD BE ADDED: AVAILABILITY OF SUBSIDIZED FINANCING FOR SOVIET COMPENSATION PROJECTS CAN MAKE THESE PROJECTS ATTRACTIVE FOR WESTERN COMPANIES WHICH FIND DIFFICULTY IN RAISING FUNDS FOR CAPITAL EXPANSION PROJECTS ELSEWHERE. FOR EXAMPLE, ITALIAN FIRMS WHICH MAY HAVE TROUBLE RAISING LARGE SUMS FOR ITALIAN DOMESTIC PROJECTS MAY FIND COMPENSATION PROJECTS IN USSR, FINANCING FOR WHICH COULD BE ARRANGED THROUGH ITALIAN GOVERNMENT- SUBSIDIZED EXPORT CREDITS, AN ATTRACTIVE ALTERNATIVE. (1). INCREASED SALES. MANY WESTERN FIRMS DO REGARD SALES OF TECHNOLOGY TO USSR AS MEANS TO RAISE FUNDS FOR DEVELOPING NEXT GENERATION OF TECHNOLOGY. AS PRACTICAL MATTER, LONG LEAD-TIME FOR COMPLETION OF SOVIET PROJECTS MEANS THAT PLANT IN QUESTION IS ALONG THE ROAD TO OBSOLESCENCE BY TIME IT COMES ON STREAM. MARKET ACCESS IS MAJOR FACTOR WHICH LEADS WESTERN FIRMS INTO COMPENSATION DEALS, PARTICULARLY IF SOVIETS MAKE CLEAR THAT PROJECT(S) IN QUESTION CANNOT BE UNDERTAKEN ON ANY OTHER TERMS. IN ADDITION, FACT THAT A COMPANY HAS BEEN PREPARED TO ENTER INTO A COMPENSATION PROJECT IS GENERALLY THOUGHT TO MAKE FIRM PERSONA GRATA IN EYES OF SOVIETS, THUS OPENING DOOR TO FLOW OF PRODUCTS FROM ABROAD ON MORE TRADITIONAL FINANCING TERMS. (2) COMPENSATION PROJECTS DO PROVIDE LONG-TERM SOURCE OF RAW MATERIALS. FOR WESTERN EUROPEAN AND JAPANESE FIRMS, THIS IS A PRINCIPAL CONSIDERATION, PARTICULARLY IF SOVIETS BALK AT SELLING OUTPUT FROM EXISTING PRODUCTION FACILITIES. SHORTAGES OF ENERGY AND TIGHTENING OF ENVIRONMENTAL CONTROLS IN OTHER COUNTRIES TEND TO MAKE SITING OF BASIC INDUSTRIES IN USSR ATTRACTIVE. SOVIETS, WITH PRESUMABLY AMPLE ENERGY RESOURCES AND LESS STRINGENT ENVIRONMENTAL SAFEGUARDS, THUS OFFER INTERESTING POSSIBILITIES FOR CHEMICAL PLANTS, SMELTERS, REFINERIES ETC. WHICH ARE BECOMING INCREASINGLY COSTLY TO CONSTRUCT ELSEWHERE. (3) EXPERIENCES OF 1973/74 SHORTAGES OF BASIC RAW MATERIALS HAS PLACED A PREMIUM ON LONG-TERM GUARANTEED LIMITED OFFICIAL USE
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SUPPLY ARRANGEMENTS. (4) ATTRACTIVENESS OF CONTRACTUAL RATHER THAN EQUITY RELATIONSHIP DEPENDS ON WHOSE MONEY IS INVOLVED. IF PROJECT IS

FINANCED ON BASIS OF GOVERNMENT-SUPPORTED CREDITS, INDIVIDUAL FIRMS WOULD DOUBTLESS FIND CONTRACTUAL ARRANGEMENT SATISFACTORY. IF FIRMS MUST PUT THEIR OWN MONEY INTO PROJECTS OR IF FIRMS MUST THEMSELVES RAISE MONEY THROUGH COMMERCIAL SOURCES, ABSENCE OF EQUITY STAKE IN SOVIET PROJECT BECOMES IMPORTANT PROBLEM AND HERE ATTITUDES OF BANKS COULD BE DETERMINING FACTOR. IMPORTANCE THIS ASPECT OF DEAL WOULD

BE MINIMIZED IF BANKS WERE PREPARED TO EXTEND FUNDS WITHOUT GUARANTEE IMPLICIT IN PLANT EQUITY. US FIRMS INTERESTED IN COMPENSATION PROJECTS

HAVE TOLD EMBASSY THAT THEY ARE CONCERNED OVER IMPACT OF INVESTMENT IN USSR ON THEIR BALANCE SHEETS, I.E. LARGE INVESTMENTS ON DEBIT SIDE NOT BALANCED BY PARTIAL OWNERSHIP OF PROJECT.

12. VII. CONSIDERATION FOR US FIRMS. A. THE MAGNITUDE OF SOVIET COMPENSATION PROJECTS, WHICH GENERALLY REQUIRE AN OUTLAY BY THE POTENTIAL TRADING PARTNER OF WELL OVER \$100 MILLION TOGETHER WITH IMPORTANT INPUTS OF SKILLED MANPOWER, TEND TO EXCLUDE THOSE FOREIGN FIRMS UNABLE TO MAKE AN INVESTMENT OF THIS SIZE IN A SINGLE MARKET WITHOUT IMMEDIATE RETURN. WITHOUT OR WITH GOVERNMENT-SUPPORTED EXPORT

CREDITS, ONLY THE LARGEST INDUSTRIAL FIRMS HAVE FELT ABLE TO GIVE SERIOUS CONSIDERATION TO SOVIET COMPENSATION PROJECT PROPOSALS. THE SOVIETS HAVE OSTENTATIOUSLY DENIED ANY DESIRE TO DISCRIMINATE BETWEEN FOREIGN COMPANIES ON GROUNDS OF SIZE, BUT THE ECONOMICS OF THEIR PROPOSALS HAVE LIMITED TRANSACTIONS WITH SMALL AND MEDIUM-SIZE FIRMS TO CASH (INCLUDING BANK-FINANCED) TRANSACTIONS. ANOTHER, RELATED PROBLEM, ARISES FROM FACT THAT SMALL TO MEDIUM-SIZED MACHINERY PRODUCERS, WHICH WOULD BE INTERESTED IN SUPPLYING EQUIPMENT FOR PROJECTS, ARE NOT IN POSITION TO UNDERTAKE MARKETING OF PLANT OFF-TAKE, WHICH IS GENERALLY IN PRODUCT AREA WITH WHICH THEY ARE UNFAMILIAR. THIS MEANS THAT A LARGE COMPANY WHICH WOULD SUPPLY TECHNOLOGY AND HANDLE

OFF-TAKE MARKETING, MUST ALMOST INEVITABLY HEAD ANY GROUP FORMED FOR A COMPENSATION PROJECT. B. TRADE OFF BETWEEN CURRENT ASSETS. FOR ANY COMPANY INTERESTED IN SOVIET COMPENSATION PROJECTS, UNUSUALLY LONG TIME REQUIRED TO BRING THESE PROJECTS ON STREAM IS MAJOR PROBLEM. LIMITED OFFICIAL USE
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ANY ASSETS INVESTED IN SOVIET PROJECT WILL BE TIED UP IN NON-PRODUCTIVE FORM FOR LONGER PERIOD THAN WOULD BE CASE WERE PROJECT BEING UNDERTAKEN ELSEWHERE. AS RULE OF THUMB, OUR ESTIMATE IS THAT CONSTRUCTION PERIOD FOR INDUSTRIAL PROJECTS IN USSR WILL BE AT LEAST 50 PERCENT LONGER THAN

TIME REQUIRED FOR SIMILAR PROJECT IN WESTERN EUROPE OR US. C. ISSUE OF VALUE OF GOODS RECEIVED. (1) SIZE AND COST OF SOVIET COMPENSATION PROJECTS INEVITABLY MEANS THAT VERY LARGE QUANTITIES OF PRODUCT MUST BE TAKEN BACK TO COVER WESTERN INVESTMENT. UNDER PRESENT CONDITIONS,

WITH MACHINERY PRICES HIGH AND RISING AND PRICES FOR RAW MATERIALS AND SEMI-FINISHED GOODS RELATIVELY DEPRESSED, ADDITIONAL OBSTACLES ARISE. FOR INSTANCE, CJB/UNION CARBIDE POLYETHYLENE PLANT SOLD FOR ABOUT DOLS 45 MILLIONS IN 1973 WOULD COST MORE THAN DOLS 60 MILLION TODAY. THUS AMOUNT OF POLYETHYLENE WHICH UC WOULD HAVE TO MARKET, GIVEN LOWER 1976 COMMODITY PRICE, WOULD BE MORE THAN 30 PERCENT GREATER

THAN UNDER 1973 DEAL. (2) BECAUSE PROJECTS UNDERTAKEN THUS FAR WITH USSR ARE ALL IN RAW MATERIAL/SEMI-FINISHED GOODS AREA, QUALITY ISSUE HAS NOT BEEN MAJOR FACTOR. WE ASSUME THAT SOVIETS WILL BE ABLE TO

PRODUCE POLYETHYLENE, AMMONIA, UREA, ETC., UP TO WORLD STANDARDS. SHOULD SOVIET MOVE INTO FINISHED GOODS AREA, HOWEVER, QUALITY ISSUE WILL BECOME CRITICAL. IN THIS CONNECTION, APPARENT IMPOSSIBILITY UNDER CURRENT SOVIET REGULATIONS OF GIVING REPRESENTATIVES OF WESTERN FIRMS A ROLE IN MANAGEMENT OF ANY SOVIET ENTERPRISE CALLS

ATTENTION TO ADJUSTMENTS WHICH SOVIETS WILL HAVE TO MAKE IN THEIR DOMESTIC PRACTICES IF THEY ARE TO SUCCEED IN ATTRACTING WESTERN FIRMS TO TAKE PART IN COMPENSATION PROJECTS INVOLVING FINISHED GOODS.

BY SOVIET DEFINITION A "COMPENSATION" PROJECT REQUIRES REPAYMENT IN PRODUCT FROM THE PROJECT, AND REPAYMENT IN FORM OF PRODUCT OF ANOTHER PLANT, IN SOVIET VIEW, IS AKIN TO BARTER, A FORM OF TRADE THEY CLAIM TO HAVE RENOUNCED. D. ISSUE OF TYPES OF GOODS. (1). UNDER CURRENT CONDITIONS WE SEE LITTLE PROSPECT FOR COMPENSATION PROJECTS IN USSR INVOLVING PRODUCTS OTHER THAN RAW MATERIALS/SEMI-FINISHED GOODS, FOR LIMITED OFFICIAL USE
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REASONS EXPLAINED ABOVE. (2). WE DO NOT BELIEVE THAT SOVIET MANUFACTURED GOODS WOULD BE ACCEPTABLE GENERALLY. (3). AS EXPLAINED ABOVE, WE DO NOT BELIEVE THAT COMPENSATION PROJECTS WHICH ARE CURRENTLY FEASIBLE IN USSR WILL INVOLVE IMPORT-SENSITIVE SECTORS IN US. E. RELATIONSHIP TO WESTERN ECONOMIC ACTIVITY. (1). DURING PRESENT WESTERN RECESSION, THERE IS NO QUESTION THAT WESTERN EUROPEAN AND JAPANESE FIRMS, WITH ACTIVE ENCOURAGEMENT IN MOST CASES FROM THEIR

GOVERNMENTS, ARE SHOWING MORE INTEREST IN TRADE WITH USSR. DIFFICULTIES MANY OF THESE FIRMS ARE EXPERIENCING IN HOME COUNTRIES AS CONSEQUENCE OF RECESSION, HOWEVER, TO SOME EXTENT MAKES LARGE CAPITAL-INTENSIVE SOVIET COMPENSATION PROJECTS MORE DIFFICULT TO UNDERTAKE. (2). OVER LONGER TERM, IMPACT ON WESTERN FIRMS OF THEIR INVOLVEMENT IN SOVIET COMPENSATION PROJECTS IS DIFFICULT TO PREDICT. WANTING ADDITIONAL CONCRETE EXPERIENCE, RESULTS OF FIAT'S INVOLVEMENT IN TOGLIATTIGRAD (ADMITTEDLY NOT FINANCED ON COMPENSATION BASIS) SUGGEST THAT WESTERN FIRMS MAY FIND SELVES BADLY BURNED BY

UNDERSTIMATING REQUIREMENTS, BOTH HUMAN AND FINANCIAL.

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13. VIII. GOVERNMENT FINANCING. A. EXIMBANK AND COMPENSATION
ARRANGEMENT. LIMITED EXPERIENCE TO DATE BY US AND INDUSTRIALIZED
WESTERN COMPANIES IN GENERAL INDICATES THAT WITHOUT EXIMBANK
PARTICIPATION IT WILL BE UNUSUAL FOR US COMPANIES TO PARTICIPATE AS
PRINCIPALS IN SOVIET COMPENSATION PROJECTS. WE UNDERSTAND THAT
INTERNATIONAL PAPER, WHICH IS CURRENTLY NEGOTIATING A COMPENSATION
DEAL WITH SOVIETS, HAS FOUND IT NECESSARY TO LOOK TO WESTERN EUROPE
FOR EQUIPMENT SUPPLY IN ABSENCE OF EXIM FINANCING. AS FAR AS CRITERIA

FOR EVALUATING INDIVIDUAL PROJECTS ARE CONCERNED, WE WOULD SUGGEST
(A) EXTENT TO WHICH US-MADE EQUIPMENT WILL BE INCLUDED - AND
THUS JOBS WITHIN US INDUSTRY CREATED, (B) PROBABILITY THAT US FIRM
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SPONSORING PROJECT WOULD MAKE INVESTMENT IN NEW PRODUCTIVE CAPACITY

WITHIN US AS ALTERNATIVE IN EXIM FUNDS FOR SOVIET PROJECT WERE NOT AVAILABLE, (C) US DOMESTIC DEMAND FOR PRODUCT TO BE TAKEN IN REPAYMENT, AND (D) LIKELIHOOD THAT NON-US COMPANIES WOULD UNDERTAKE PROJECT IN QUESTION IF AMERICAN FIRMS WERE UNABLE TO PARTICIPATE DUE TO ABSENCE OF EXIM FINANCING. B. OTHER WESTERN GOVERNMENTS' POLICIES. TO DATE, OTHER WESTERN GOVERNMENTS HAVE FOLLOWED POLICIES RANGING FROM RELATIVE DISINTEREST (IN CASE OF FRG, WHICH OFFERS NO GOVERNMENT-SUBSIDIZED PURCHASE CREDIT BUT DOES PROVIDE SUPPLIERS' CREDITS) TO RELATIVELY STRONG SUPPORT (IN CASE OF UK, FRANCE, ITALY AND JAPAN). SMALLER WESTERN COUNTRIES GENERALLY HAVE NOT MADE AVAILABLE SUFFICIENT VOLUMES OF CREDIT TO PERMIT INVOLVEMENT OF THEIR FIRMS IN COMPENSATION PROJECTS IN ROLE OF PRINCIPAL OR PRIME CONTRACTOR. FINLAND IS IN SOMEWHAT SPECIAL POSITION, AND FINNISH FIRMS ARE ACTIVELY INVOLVED, WITH STRONG GOVERNMENT SUPPORT, IN COMPENSATION PROJECTS INVOLVING IRON ORE AS WELL AS PULP AND PAPER.

14. IX. RELATIONSHIP OF COMPENSATION ARRANGEMENT TO GATT. FROM OUR PERSPECTIVE, THERE APPEARS NO SHORT OR MEDIUM TERM PROSPECT THAT USSR WILL SEEK GATT MEMBERSHIP OR THAT IT WILL TAKE STEPS REQUIRED TO QUALIFY FOR GATT MEMBERSHIP. SOVIETS HAVE TRADED AND SHOW ALL SIGNS OF WISHING TO CONTINUE TO TRADE ON BILATERAL BASIS. COMPENSATION PROJECTS INVOLVING SOVIETS AND FIRM(S) FROM SINGLE WESTERN COUNTRY WILL TEND TO REINFORCE THIS BILATERALISM. BUT GIVEN SIZE OF SOVIET PROJECTS, STRONG PRESSURES FOR MULTINATIONAL APPROACHES ON WESTERN SIDE SEEM CERTAIN TO EMERGE. FROM POINTS OF VIEW BOTH OF FINANCING REQUIREMENTS AND OF MARKETING OF PRODUCT TAKEN IN PAYMENT, RESOURCES AVAILABLE FROM ANY ONE WESTERN EUROPEAN COUNTRY WILL BE INSUFFICIENT FOR SEVERAL OF USSR'S LARGER MULTI-BILLION DOLLAR PROJECTS. CONSEQUENTLY SOVIETS MAY FIND THEMSELVES SLIPPING INTO MULTILATERAL TRADING PATTERNS AS THEY DEAL WITH MULTINATIONAL CONSORTIA OF FOREIGN FIRMS ON COMPENSATION PROJECTS.

15. WITH RESPECT TO SPECIFIC QUESTIONS, WE BELIEVE THAT:
A) COMPENSATION PROJECTS WILL SERVE TO SPUR PROCESS ALREADY UNDER WAY LEADING TO DEGREE OF ECONOMIC INTERDEPENDENCE BETWEEN USSR AND WEST; B) SOVIETS WILL CONTINUE TO PREFER BILATERAL APPROACHES

TO TRADE AND COMPENSATION PROJECTS WILL NOT PER SE ALTER THEIR BASIC PREFERENCES; C) WE SEE SOME ANTICOMPETITIVE POSSIBILITIES ON LIMITED OFFICIAL USE
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WESTERN SIDE IF, AS WE EXPECT, LARGE WESTERN EUROPEAN FIRMS ARE OBLIGED TO FORM AD HOC COMBINATIONS FOR UNDERTAKING COMPENSATION PROJECT IN USSR - ALL THE MORE BECAUSE SOVIETS ARE ABLE THROUGH STATE TRADING MECHANISM TO CONTROL COMPETITION AMONG INDIVIDUAL WESTERN FIRMS FOR SPECIFIC SOVIET CONTRACTS; D) IF SOVIETS ARE SUCCESSFUL IN ATTRACTING WESTERN COMPANIES AND GOVERNMENTS INTO ACTIVE PARTICIPATION IN COMPENSATION PROJECTS, THERE WILL DOUBTLESS BE SOME DIVERSION OF INVESTMENT RESOURCES, BUT IT IS DIFFICULT IF NOT COMPLETELY IMPOSSIBLE TO DETERMINE WHETHER THESE

RESOURCES WOULD HAVE BEEN USED ELSEWHERE HAD THEY NOT BEEN PUT INTO SOVIET COMPENSATION PROJECT. BY SAME TOKEN, LARGE-SCALE COMPENSATION PROJECTS WILL BRING ABOUT NEW AND SUBSTANTIAL TRADE FLOWS; E) IN RESPONSE TO PARTICIPATION BY THEIR FIRMS IN COMPENSATION PROJECTS WESTERN GOVERNMENTS WILL HAVE TO CONSIDER CERTAIN CHANGES IN THEIR TRADE POLICIES VIS-A-VIS THE USSR IN ORDER TO MAKE POSSIBLE IMPORT OF LARGE QUANTITIES OF PRODUCT ACCEPTED IN REPAYMENT UNDER COMPENSATION TERMS.

16. X. POTENTIAL PROBLEMS. A. LABOR ATTITUDES, WHILE EMBASSY IS NOT QUALIFIED TO ASSESS ATTITUDES OF US LABOR, WE WOULD ANTICIPATE COOL RESPONSE TO IDEA OF PARTICIPATION BY AMERICAN FIRMS IN SOVIET COMPENSATION PROJECTS, PARTICULARLY IF GOVERNMENT SUPPORT IMPLIED IN EXIMBANK FINANCING WERE PRESENT. B. BUSINESS COMMUNITY ATTITUDES. THOSE COMPANIES WHICH HAVE SENT REPRESENTATIVES TO MOSCOW ARE UNDERSTANDABLY FAVORABLE TO COMPENSATION CONCEPT AS ASPECT OF INCREASINGLY FAVORABLE SOVIET BUSINESS CLIMATE. C. OTHER PUBLIC ATTITUDES. D. CONGRESSIONAL ATTITUDES.

17. XI. POLICY GUIDELINES. EMBASSY BELIEVES TREND TOWARD CONCLUSION OF MAJOR CONTRACTS BETWEEN SOVIETS AND WESTERN FIRMS ON COMPENSATION BASIS WILL CONTINUE, WITH OR WITHOUT PARTICIPATION OF AMERICAN INDUSTRY. RECOGNIZING THAT COMPENSATION PROJECTS WILL REPRESENT AN INCREASINGLY SUBSTANTIAL PORTION OF SOVIET UNION'S TRADE WITH INDUSTRIALIZED WEST, IT WOULD SEEM ADVANTAGEOUS TO ENCOURAGE US FIRMS TO SEEK OPPORTUNITIES TO PARTICIPAL IN THESE

PROJECTS IF SUCH OPPORTUNITIES ARE CONSISTENT WITH THEIR COMMERCIAL INTEREST. IN ABSENCE OF EXIMBANK FINANCING, DEIRECT US SHARE IN MOST LUCRATIVE ASPECTS OF THESE DEALS, I.E. THE EQUIPMENT/MACHINERY SUPPLY, WILL BE LIMITED. OTHER FACTORS BEING EQUAL, IT WOULD SEEM PREFERABLE FOR US INDUSTRY TO BE INVOLVED IN THIS PROCESS EVEN IN LIMITED OFFICIAL USE
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SUBORDINATE OR SECONDARY ROLE WHEN ALTERNATIVE IS TO ABANDON ALL INVOLVEMENT TO OTHERS. AVAILABILITY OF EXIMBANK FINANCING AT SOME FUTURE DATE WOULD MATERIALLY CHANGE CONDITIONS UNDER WHICH US COMPANIES COULD APPROACH THESE PROJECTS. IN MEANTIME, AVAILABILITY OF LARGE VOLUME OF GOVERNMENT-SUPPORTED CREDITS FROM OTHER WESTERN COUNTRIES WILL REMAIN AMONG CHIEF DETERMINANTS IN CHANNELLING SOVIET CHOICES OF WESTERN PARTNERS IN COMPENSATION PROJECTS TOWARD FIRMS FROM THOSE COUNTRIES.
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